

REFORMING THE CULTURE OF FINANCIAL REPORTING: THE PCAOB AND THE METRICS FOR ACCOUNTING MEASUREMENTS

JAMES D. COX*

The financial bubble that burst in 2000 began a meltdown of stock prices that ultimately removed an estimated \$8.5 trillion from the Nasdaq market alone.¹ This painful process did not occur quickly, but like the bubble that preceded it, transpired over several years. Thus, history was recently made when a third consecutive calendar year ended with the major stock indices below their earlier year-end levels.² Over these three dark years, retirees have seen their salad days disappear, to be replaced by beans and franks. Others have placed their plans for early retirement on hold. These have not been good times for U.S. financial markets.

The collapse of the U.S. securities markets has yielded Darwinian-like effects. Frail companies who could conceal their weaknesses when a rising tide of euphoria lifted all boats have crashed on the reality shoals created by the now-withered optimism of investors. Also damaged in the process was our assurance that the U.S. regulatory climate provided the level of protection to investors to merit their on-going confidence.³ Thanks to the financial frauds that are being revealed by Enron, Global Crossing, WorldCom, Tyco and the like, hiding money in the mattress rather than investing it in the market is a more credible choice these days than it was in the 1990s. Each of these were cause in themselves to make us question what happened to the many safeguards believed to be in place to protect

* Brainerd Currie Professor of Law, School of Law, Duke University. The author is grateful for the comments received from Professors Kelly Richmond Pope and Robert W. Hillman on an earlier draft of this paper and to the excellent research assistance of Ms. Gitanjali Lakhota and Mr. Daniel O'Neill.

1. See, e.g., Editorial, *Cutting Interest Rates Won't Halt Deflation*, ST. LOUIS POST-DISPATCH, Nov. 5, 2002, at B6. Estimates of the overall market loss range widely.

2. Kate Kelly, *Industrials Near Worst Year Since '77; Nasdaq May See Third-Biggest Drop*, WALL ST. J., Dec. 31, 2002, at C1. Further evidence of the adverse effects of the market's collapse are the efforts of insurance companies who are approaching state legislatures to reduce from three percent to one-and-one-half percent the amount of gain they will guaranty for standard annuity contracts. See Bridget O'Brian, *Insurers Find It Hard to Guarantee 3% Return*, WALL ST. J., Dec. 4, 2002, at C1. There has been also the disappearance of the IPO market.

3. Estimates of the harm caused by the financial frauds vary. See, e.g., Mike McNamee et al., *Accounting Wars*, BUS. WK., Sept. 25, 2000, at 157 (losses attributable to accounting failures between 1993-2000 are at least \$88 billion) [hereinafter McNamee et al.]. A somewhat different focus is on the estimates of costs related to corporate governance failures for which the Brookings Institute placed a \$35 billion cost on the economy. See Alan Beattie, *Corporate Scandals Will Cost U.S. \$35 bn*, FIN. TIMES, Sept. 5, 2002, at P8.

investors. Further disquiet is found in the significant increase in earnings restatements.⁴ After all, one can well view earnings restatements as fraudulent reporting *sans* scienter. In combination, the parade of financial horrors over the last year has made us reexamine the fixtures that for decades were the cornerstones of the U.S. financial regulatory system.

No good national malaise goes unrecognized or unrewarded by Congress. Post-Enron, there were few congressional committees and subcommittees that did not convene to investigate, posture, and propose reforms. And, just when things began to simmer down a bit in Congress, financial frauds returned to the front pages of the financial press with the book-cooking allegations by WorldCom and then AOL-Time Warner. This was too much to resist for the recess/election bound Congress. So, Congress acted. The result was the passage of the Sarbanes-Oxley Act of 2002 on July 29, 2002, the most significant amendment to the U.S. securities laws in their seventy-year history.

Sarbanes-Oxley itself reflects the belief that an important contributing factor to the financial maelstrom is that U.S. generally accepted accounting principles (GAAP) have become too rule-oriented.⁵ People

4. In 1990, there were thirty-three earnings restatements. In five years, the number of restatements increased by fifty percent to fifty restatements. In 2000, there were 157 earnings restatements, more than triple the number five years earlier and five times the number at the beginning of the decade, and in 2002, this number reached a record high of 330. See Huron Consulting Group, *An Analysis of Restatement Matters: Rules, Errors, Ethics, For the Five Years Ended December 31, 2002* (Jan. 2003); Min Wu, *Quantitative Measures of the Quality of Financial Reporting* (June 2001) (unpublished paper on file with author). See generally GAO, *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges*, GAO-03-138 (Oct. 4, 2002). Earnings statements are accompanied by price adjustments in the security of the restating firm. One estimate places the loss in market value due to restatements made for the period 1998-2000 at seventy-three billion dollars. See George B. Moriarty & Philip B. Livingston, *Quantitative Measures of the Quality of Financial Reporting*, 17 FIN. EXECUTIVE 5, 56 (2001). The GAO estimated unadjusted market losses of \$100 billion. See GAO, *Financial Statement Restatement Database*, GAO-03-395R (Jan. 17, 2003). Earnings restatements are symptomatic of the aggressive and opportunistic use of accounting principles. Opacity and lacunae in accounting metrics were shamelessly exploited by the firms' managers. Too frequently, it appears, the public accountants accorded their audit clients the benefit of any ambiguity in accounting principles.

5. Therefore, Section 108 of Sarbanes-Oxley provides that the SEC is to undertake a study of the adoption of a more principles-based reporting system and to report its results to Congress by July 2003. Pub. L. No. 107-204, 116 Stat. 745, § 108 (2002). See SEC Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (2003), available at <http://www.sec.gov/news/Studies/principlesbasedstand.htm> (last visited Sept. 3, 2003) [hereinafter SEC Study of Principles-Based Accounting]. The chief accounting standard setting body, the Financial Accounting Standards Board, has itself heard the call and begun its own consideration of whether and how the metrics for financial reporting can be more principles-based. See FASB Proposal: Principles-Based Approach to U.S. Standard Setting, No. 1125-001 (Oct. 21, 2002), available at http://www.fasb.org/proposals/principles-based_approach.pdf (comparing the effects of each approach) [hereinafter FASB Proposal].

In fact, the debate regarding rules versus principles has long been part of the unrest that has

with this belief insist that financial reporting, and most particularly, GAAP, should instead be more principles-based with less emphasis on elaborate sets of rules regarding the measurement of assets, liabilities, revenue, and other financial items.⁶ Stated somewhat differently, over time GAAP has evolved so that authoritative statements, such as the statements issued by the Financial Accounting Standards Board, bear a strong resemblance to the much maligned regulations of the Internal Revenue Code.⁷ With so many rules, and their seemingly endless qualifications, it is too easy for the accountant to rationalize that if a specific treatment is not prohibited, then it must be permissible. Hence, the reasoning is that the abundance of technical rules leads naturally to the trees obscuring the

surrounded the accounting standard setting. The committee that was formerly headed up by Francis Wheat and that provided the momentum for replacing the then Accounting Principles Board (APB) with the FASB did so because it believed standards developed by the APB were not principles at all and should have greater specificity. See AICPA, Standards, Report of the Study on Establishment of Accounting Principles 13 (Chaired by Francis M. Wheat). The debate also is not isolated to the United States. See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before U.S. Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Sir David Tweedie, Chairman, International Accounting Standards Board) (observing that detailed rules with bright lines are counter-productive and lead to a serious risk of obscuring the underlying principles). An excellent discussion of the choice between principles and rules appear in Katherine Schipper, *Principles-Based Accounting Standards*, 17 ACCT. HORIZONS 61 (2003); AAA Financial Accounting Standards Comm., *Evaluating Concepts-Based vs. Rules-Based Approaches to Standard Setting*, 17 ACCT. HORIZONS 73 (2003); Mark W. Nelson, *Behavioral Evidence on the Effects of Principles- and Rules-Based Standards*, 17 ACCT. HORIZONS 91 (2003).

6. The most visible of those making the call was former SEC Chairman Harvey Pitt. See *The Sarbanes-Oxley Act of 2002: Hearing on Accounting and Investor Protection Issues Raised by Enron and Other Public Companies Before the U.S. Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Harvey Pitt, Chairman, Securities and Exchange Commission). See also Susan S. Bies, Federal Reserve Board Governor, Address to Carnegie Endowment for International Peace, in *Other Developments*, Fed. Sec. L. Rep. (CCH) No. 2046 (2002); *Corporate Accounting Practices: Is There a Credibility GAAP?: Hearing Before the House Subcomm. on Capital Markets, Insurance and Government*, 107th Cong. (2002) (statement of Edmund L. Jenkins, Chair, Financial Accounting Standards Board).

7. The most frequently raised example of this is FASB, *Amendment of Statement 133 on Derivatives Instruments and Hedging Activities*, FIN. ACCT. SERIES (May 1, 2002). Appendix A of FASB Proposal, *supra* note 5, provides a clear illustration of the complexity of FASB Statement 133 by demonstrating how a rule can grow increasingly complex in creating exceptions to its own exceptions. The source of the complexity of this pronouncement is not solely that derivative instruments are inherently complex and are multidimensional, but that businesses and their auditors sought numerous exceptions to avoid valuing the derivatives at their fair market value, a result that would have caused greater variability in the reporting company's earnings. See Lynn E. Turner, "Cookbook For Reform: Lessons Learned From Fraudulent Financial Reporting," Address to American Institute of Certified Public Accountants, National Conference on Advanced Litigation Services and Fraud (Oct. 31, 2002). See also FASB Proposal, *supra* note 5, at 2 (stating that the detail and complexity in accounting statements "has been demand-driven").

vision of the dominating forest. As such, the audit opinion may stand for nothing more than the absence of the auditor finding no violation of the rules, and not that the financial statements fairly present the company's financial performance or position. Those who champion a more principles-based orientation would eliminate the exceptions and qualifications of the present pronouncements and replace them with more encompassing standards.

The complaints against rules-based standards occur on several levels. First, there is the view that rules, like trees, can obscure the more accurate view of the financial forest that management has tended. That is, the presence of bright-line tests invites focusing on details and losing sight of the guiding principle that the financial statements should fairly present the financial position and performance of the reporting company. A second ground for complaint is that of efficiency. Accounting standards have become so complex that they dwarf the capacity of the professional who prepares the statements and the sophisticated analyst to interpret what is thereby communicated so that neither competently performs his task.⁸ American accounting standards, so the complaint goes, have reached a level where the medium is not understood due to the inherent complexity of the reporting metrics that guide the message.

This Article approaches the principles versus rules debate from the cultural perspective of the American boardroom with an emphasis on the monitoring model's dependence on not just the independence of directors, but on their outside advisors. Part I examines the evolution of the audit committee with special emphasis on the recent contributions of Sarbanes-Oxley and the amended listing requirements of the New York Stock Exchange and Nasdaq to strengthen the independence of the audit committee. Part II provides a more sobering image by examining the inertial forces that today's reform efforts must overcome if progress is to be made toward greater independence of auditors from their client's management. The substantive legal environment of rules-oriented systems is examined in Part III. Finally, Part IV concludes this Article on a hopeful note of the promise of the newly created Public Company Accounting Oversight Board (PCAOB). The overall thesis of this Article is that

8. A graphic illustration of this is the measurement provided by Mr. Frederick Gill, senior technical manager of the AICPA. Mr. Gill reports that the original pronouncements of the FASB plus its all important FASB Emerging Issues Task Force consensus stand seven inches high, thus dwarfing the more principles-based standards of the International Accounting Standards and its interpretations which stand a mere two inches. See Frederick Gill, *Principles-Based Accounting Standards* (Feb. 15, 2003) (unpublished paper on file with author).

outside directors should be the strongest proponents for an activist PCAOB.

I. THE AUDIT COMMITTEE IN THE POST-ENRON ERA

The audit committee has long been a vital organ for improving the health of corporate governance. In 1999, the New York Stock Exchange (NYSE), Nasdaq, and the American Stock Exchange (AMEX) mandated that listed companies have an audit committee comprised of at least three independent directors.⁹ Just a few years earlier, the American Law Institute Corporate Governance Project, in the face of stiff opposition from its members against a more mandatory edict, had to soften its call for audit committees of large public companies to adhere to the good corporate practices it recommended.¹⁰

What is remarkable in the reforms introduced by Sarbanes-Oxley is that they follow soon after the SEC's own Blue Ribbon Committee gave rise to important changes in the listing requirements of the NYSE, Nasdaq, and AMEX exchanges.¹¹ The cause of the SEC empanelling the Blue Ribbon Committee was a 1999 study of companies charged by the SEC with financial fraud from 1987 to 1997. The study found that twenty-five percent of the surveyed companies did not have an audit committee, that of those that did have an audit committee, nearly one-third of the committee members' independence was compromised by close relationships with, or actual participation in, the company's management, and that sixty-five percent of the committee members lacked accounting or financial expertise.¹² In response to the report, the listing requirements for each of the markets were modified. The changes introduced, which are substantially identical across the NYSE, Nasdaq, and AMEX, included the following: each listed firm must have an audit committee of three

9. See NYSE Rulemaking, Securities Exchange Act Release No. 42,233, 71 SEC Docket 639 (Dec. 14, 1999) (approving changes in the NYSE listing requirements for audit committees); NASD Rulemaking, Securities Exchange Act Release No. 42,231, 71 SEC Docket 624 (Dec. 14, 1999) (approving changes in listing requirements for Nasdaq and AMEX for audit committees).

10. See ALI, 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 305 (1992) (recommending audit committee for companies with 2,000 shareholders and \$100 million in assets). Audit committees have been a fixture of the American corporate governance scene for sometime. A 1979 study by the American Society of Corporate Secretaries found that 963 of 993 respondents in its study had an audit committee. *Id.* at 107 n.4.

11. See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, reprinted in 54 BUS. LAW. 1067 (1999).

12. See Mark S. Beasley et al., *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies* (monograph published by the Committee of Sponsoring Organizations of the Treadway Commission, 1999).

“independent directors” (in exceptional circumstances one member may be non-independent); the definition of independence requires, among other factors, that each audit committee member not have been an employee within three years or received (excluding board fees) compensation greater than \$60,000 (the NYSE expressed this limitation more generally, proscribing a relationship that would impede the director’s independence); each member must be financially literate; one member must have financial sophistication, such as employment experience in finance or accounting; and each audit committee must have a written charter.¹³ The Blue Ribbon Committee’s proposals not only gave rise to changes in the listing requirements, but also the SEC amended its disclosure requirements to complement the tightened independence requirements and obligations of the audit committee.¹⁴ For example, each audit committee is required, on the issuer’s annual Form 10-K, to disclose whether its recommendation that the financial statements be included in the annual report was based on its discussions with management and the independent accountant.¹⁵ Another central disclosure requirement is mandating disclosure in each proxy statement about whether the company has an audit committee. Finally, every three years the proxy statement must set forth the duties and responsibilities of the audit committee as stated in its charter.¹⁶

In the hearings that preceded the enactment of Sarbanes-Oxley, witnesses frequently testified that the auditing process may be compromised because auditors view their responsibility as serving the company’s management and not the full board of directors or, for that matter, the shareholders.¹⁷ This raises two important concerns. Auditors who understand that their future retention depends on the very managers whose financial statements they are to review will behave accordingly. They will not make firm challenges to the accounting decisions made by management knowing that by doing so they jeopardize their continuing

13. For an excellent review of the developments preceding the changes in listing requirements with respect to audit committees and a comparison of the NYSE, AMEX, and Nasdaq listing modifications after the Blue Ribbon Committee’s report, see Joseph I. Goldstein & Jeffrey F. Robertson, *Modifications to Audit Committee Requirements May Increase Director Liability*, 32 SEC. REG. & L. REP. 1104 (2000).

14. See Audit Committee Disclosure, Exchange Act Release No. 42,266, 71 SEC Docket 787 (Dec. 14, 1999).

15. See Item 306(a)(4) of Regulation S-K, SEC Integrated Disclosure System for Small Business Issuers, 17 C.F.R. § 228.306(a)(4) (2000). This disclosure is accompanied by the names of the audit committee members and has as one of its purposes to link more closely the audit committee members to the financial statements included in the annual report.

16. See Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934, 17 C.F.R. § 240.14a-101, Item 7(d)(3)(ii) & (iii) (2000).

17. See generally S. REP. NO. 107-205, at 31 (2002).

relationship with the client. Also, auditors who view their professional relationship to be with the company's managers, and not its directors or stockholders, are more likely to view inquiries put to the auditors by the outside directors as intrusive or simply irrelevant to their engagement.

Concerns related to the independence of the auditors from the company's managers are central to Sarbanes-Oxley.¹⁸ A key provision of the Act anchors the accountant's relationship in the audit committee and not in management.¹⁹ The Act further buttresses its separation of the auditor from the managers by tightening the definition of independence for audit committee members from that embraced just a few years earlier by the Blue Ribbon Committee. To do this, the Act mandates that audit committees maintain procedures to address complaints regarding the issuer's accounting, internal controls, or other auditing related matters and empowers audit committees to engage, as necessary, independent advisors at the issuer's expense.²⁰ Pursuant to authority set forth in a companion provision, the SEC has adopted criteria for a member of an audit committee to be considered a "financial expert," and reporting companies are now required to disclose whether their audit committee includes a financial expert, and if not, the reasons for not having such a person on the committee.²¹ The importance of financial expertise on the audit committee is supported by a comprehensive study of governance criteria linked to earnings restatements. The study found that mere independence of the board or the audit committee was unrelated to the likelihood of a company encountering an earnings restatement; however, the probability of an earnings restatement was significantly negatively correlated with the audit committee composed of those with an accounting or finance background.²²

18. See generally Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449 (2002).

19. See Sarbanes-Oxley Section 301, 15 U.S.C.A. § 78j-1 (West 2002) (amending Section 10A of the Exchange Act, 15 U.S.C. § 78f and mandating that the SEC direct that the exchanges and the NASD adopt rules that provide that the audit committee "shall be directly responsible for the appointment, compensation, and oversight of the work" of the company's auditor). A few months before Sarbanes-Oxley was enacted, both the NYSE and Nasdaq tightened several of their governance requirements in areas that were later dealt with by Sarbanes-Oxley. For example, the proposed listing changes for both bodies require that audit committees must have the authority to retain and terminate the auditor. This requirement is, as seen above, now reflected in Sarbanes-Oxley.

20. See *id.* (barring any compensation to the audit committee member except director fees, whereas previously, independence existed so long as the amount received did not exceed \$60,000). The SEC does, however, have authority to grant exemptions as it deems appropriate. *Id.*

21. See 17 C.F.R. § 229.401(h) (2003) (listing criteria for consideration); Item 401(h) of Regulation S-K, 17 C.F.R. § 229.401(h)(2) (2003) (establishing a three-part test for a financial expert); Item 309 of Regulation S-K, 17 C.F.R. § 229.401(h)(1) (2003) (requiring disclosure of whether the audit committee includes a "financial expert").

22. See Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Standards*

Importantly, the SEC's new rules, as well as the listing requirements of the NYSE and Nasdaq, impose a dialogue between the audit committee and the outside accountants for the purpose of eliciting any warning signs in the reporting system or management's disclosure policies and practices. The auditor is to report, among other factors, on material issues that have surfaced in its assessment of the firm's internal controls as well as any discussions it has had with management regarding the firm's internal controls. The auditor must also share with the audit committee written communications it has had with management regarding "critical" accounting decisions as well as identify "critical" areas of the financial reports where an accounting estimate or principle change would affect the quality of the presentation.²³ The listing requirements also mandate a discussion between management and the audit committee covering a range of topics, including a review of the quarterly and annual reports, earnings press releases, and earnings guidance given to analysts.²⁴

II. RECIPE FOR THE DEATH OF A PROFESSION

CPAs view themselves as members of a profession because auditors impose upon themselves social obligations that transcend the client-accountant relationship. This vision is correct in the sense that, as Dean Roscoe Pound so aptly observed, an organized profession is not "the same sort of thing as a retail grocers' association."²⁵ The central word in the acronym for the auditors' profession, CPA, is "public." This six-letter word carries with it great meaning for it reflects the auditors' undertaking to carry out their independent attest function²⁶ pursuant to professional standards, namely that the financial statements have been reviewed

(May 2003) (unpublished paper, on file with author), *available at* <http://bama.ua.edu/~aagrawal/restate.pdf>. The author's data also shows that the negative correlation is strengthened further if the audit committee includes the company's chief financial officer (CFO). They explain the puzzling result with respect to the CFO being a member of the audit committee as the CFO providing a convenient channel for the flow of pertinent information that enables the committee to be more effective.

23. See Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07 (2003).

24. See, e.g., New York Stock Exchange Corporate Accountability and Listing Standards Committee Recommendation 7 (2002), *available at* <http://www.NYSE.com/regulation/p1026568597>.

25. See ROSCOE POUND, *THE LAWYER FROM ANTIQUITY TO MODERN TIMES* 7 (1953).

26. Skeptics may question whether auditors actually see themselves as professionals or merely pretend to be professionals. Such doubt is fed by the astonishing discovery by the SEC of 8,000 violations by PricewaterhouseCoopers accountants of the prohibition against owning stock in their audit clients; the investigation revealed that thirty-one of forty-three top partners owned stock in their audit clients. See JERRY W. MARKAM, III, *A FINANCIAL HISTORY OF THE UNITED STATES, FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM* (1970-2001) 257 (2002).

pursuant to a body of generally accepted auditing standards. In light of that review, the auditors can certify that they were prepared in accordance with GAAP and fairly present the financial performance and position of the firm.

It should be noted that the principles-rules debate has no natural connection to the clearly fraudulent reporting practices engaged in by Enron, WorldCom, and the other recently scandalous companies.²⁷ Much of what has captured our attention was straightforward defiance of GAAP; the accounting and financial scandals were not the product of technical compliance with the metrics for financial reporting that nonetheless presented a false picture of the firm's position or performance. The choice between principles or rules is implicated in the financial and accounting scandals, however, because the scandals invite close scrutiny of the auditors as professionals and the role of accounting metrics in auditing and their connection to professionalism. The question, therefore, is not what went wrong with the metrics but why misapplications of the metrics were not caught by the outside auditors. There is a further connection between professionalism and the rules-principles debate. Absent unambiguously articulated and finite reporting metrics, the norm for a principles-based accounting world, financial reporting will involve more areas of judgment in which decision-making can possibly be influenced by the self-interest of the accountant. Professionalism, of course, requires that self-interest not be part of the judgment process. Simply put, the causes for the accountants' blindness that caused them not to question blatant material misrepresentations in Enron²⁸ are not likely to be any less present, and in fact are likely to enjoy an even greater frequency, when matters involve numerous discrete judgments called for by ambiguous or broad accounting principles rather than a straightforward misapplication of a rule, as was the case in Enron. If this connection is accepted, then there is much in both recent history and the present environment of public accounting that makes the choice of principles over rules a disturbing outcome.

The prime suspect for the accounting profession's recent sorrowful performance as a gatekeeper against financial fraud is the rising importance of nonaudit services in overall operations of the major

27. See, e.g., John R. Emshwiller, *Enron May have Improperly Moved Up To \$5 Billion*, WALL ST. J., Mar. 6, 2003, at B7 (summarizing report prepared in connection with the Enron bankruptcy finding that improper use of accounting fabricated ninety-six percent of Enron's net income for 2000 and concealed over \$10 billion in debt).

28. William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002).

accounting firms. In 1976, audit fees constituted seventy percent of accounting firm revenues; by 1998 audit fees had fallen to thirty-one percent of their revenues. These changes occurred because nonaudit revenues were increasing three times faster than were revenues from audit services.²⁹ There are multiple reasons why the accounting firms placed such an emphasis on growing their nonaudit services revenues. An unwitting accomplice in this effort was the effort of many audit committees to gauge their success by reducing the auditor's fees rather than, for example, enhancing the quality of the audit.³⁰ The pressure on audit fees also gave rise to a need for accounting firms to distinguish themselves from their competitors by offering a wider range of services.³¹ There was, of course, the quest to share the good life enjoyed by the well-compensated investment bankers and others with whom the accountants frequently interacted.³² Much of the revenue growth for nonaudit services was based solely on client demand; clients, believing that their auditors knew the clients' businesses better than anyone else, concluded that there would be economies of scale by retaining the auditors for a range of consulting services rather than selecting a provider that was unfamiliar

29. ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW 116 (2002); McNamee et al., *supra* note 3, at 157. Between 1990 and 1999, audit fees generated by the Big Five accounting firms for SEC registrants declined from seventy-one percent to forty-eight percent of total revenues while fees for tax work increased from seventeen percent to twenty percent, and consulting grew from twelve percent to thirty-two percent. See Public Oversight Board, *The Panel on Audit Effectiveness Report and Recommendations* 112 (Aug. 31, 2000), at <http://www.pobauditpanel.org/>. In absolute terms, the total 1999 revenues of the Big Five accounting firms derived from SEC registrants was \$26.5 billion; of this amount, \$9.5 billion was generated from auditing fees. *Id.* See also Public Accounting Report Special Supplement Annual Survey of National Accounting Firms (2001) (providing a breakdown of revenue sources for the Big Five accounting firms). One study found that nonaudit revenues paid by 1,224 companies to their auditors were 2.5 times higher than audit revenues. See Gretchen Morgenson, *Watchdog? Lap Dog? Why Have to Guess?*, N.Y. TIMES, Feb. 17, 2002, § 3, at 1 (discussing a 2001 study by Investor Responsibility Research Center). The IRRC repeated its study in 2002 with similar results. See Press Release, Investor Responsibility Research Center Finds Little Change in Potential Auditor Conflicts, available at http://irrc.org/press_releases (Oct. 9, 2002) (finding that seventy-two percent of total fees paid by 1,245 SEC registrants were for nonaudit services). See also *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Bevis Longstreth, member, O'Malley Comm.) (reporting there is a 2.69: 1 ratio of nonaudit to audit fees).

30. See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Roderick M. Hills, Chairman, Securities and Exchange Commission 1975-77).

31. See Prepared Statement of Arthur R. Wyatt before the Senate Banking, Housing and Urban Affairs Committee, Feb. 27, 2002.

32. See Ianthe Jeanne Dugan, *Depreciated: Did You Hear the One About the Accountant? Its Not Very Funny*, WALL ST. J., Mar. 14, 2002, at A1.

with the clients' businesses and support systems.³³ A further concern was the intense competition among accounting firms to recruit talent to the quiet life of the auditor. Consider that the number of accounting majors declined twenty-five percent between 1995 and 2000, matching a near identical decline in the number of individuals sitting for the national CPA exam.³⁴ To attract talented auditors, the accounting firms had to offer a broader professional profile than being solely an auditor.³⁵ This strategy also complemented the reality that auditing work had become more complex and technical by the 1990s so that audit teams needed to include technical non-accounting experts who would have been underemployed absent consulting opportunities.³⁶

From the various realities that attracted auditors and their clients to the joint proposition that the auditors should carry out both consulting and auditing assignments, it was but a short step before these same realities spun a web that obscured the auditors from their primary professional undertakings. The popular media may rightly have characterized the role of auditing services with the national accounting firm's repertoire as a "loss leader" whereby the provision of audit services enabled the accountants to get their foot in the door so that they could thereafter provide more lucrative consulting services.³⁷ Certainly, there is the lingering question why auditing could not be more lucrative than it was. After all the industry was dominated by a few national players—first the Big Eight, then the Big Five, and now the Final Four—so that one would have expected the industry to perform more as a cartel that earned

33. See Public Oversight Board, *Panel on Audit Effectiveness Report and Recommendations* 110-11 (Aug. 31, 2000), available at <http://www.pobauditpanel.org>; McNamee et al., *supra* note 3, at 156.

34. See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement by William E. Balhoff, Chairman, Executive Committee AICPA Public Company Practice Section) (the number of accounting majors declined from 60,000 in 1995 to 45,000 in 2000 and observing that in the decade 1991-2000 the total number of those taking the CPA exam had declined thirty-three percent).

35. See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement by James E. Copeland, CEO, Deloitte & Touche) ("The best and the brightest seek positions that will allow them to develop their expertise, to learn, to work on cutting-edge issues. . .").

36. See Public Oversight Board, *Panel on Audit Effectiveness Report and Recommendations* 112 (Aug. 31, 2000), available at <http://www.pobauditpanel.org>.

37. See Noam Scheiber, *How Arthur Andersen Got Away With It: Peer Review*, THE NEW REPUBLIC, Jan. 28, 2002, at 19. Consistent with the loss leader thesis is an Arthur Andersen internal memorandum imposing a cap on the firm's audit fees charged Waste Management Company because the client was viewed as a "crown jewel" with respect to the level of nonaudit revenues provided by Waste Management. See *Arthur Andersen LLP Agrees to Settlement*, SEC News Release No. 2001-62 (June 19, 2001), available at 2001 WL 684751 [hereinafter *Arthur Anderson LLP*].

oligopolistic profits. And they offered a product—auditing—for which there is no substitute from a more competitive market and which their customers were required by law to purchase. The “loss leader” thesis suggests that the accounting firms instead pursued a strategy to use the marketing power they enjoyed in one segment—the provision of audit services—to enter a more competitive and extremely lucrative consulting segment.

Certainly the behavior of the national accounting firms is consistent with the loss leader thesis. For example, Ernst & Young set targets for nonaudit services that audit engagement partners were to meet with respect to each client; missing a target resulted in a ten percent salary reduction.³⁸ These developments had an obvious impact on the culture of auditing firms because firm leadership roles were more likely to be bestowed on those who were successful marketers rather than the most diligent and talented auditors.³⁹ For example, Arthur Andersen’s engagement partner for Waste Management Company, a company that would be the focus of among the largest reporting violations to occur in the 1990s, was Robert Allgyer, a marketing director in Arthur Andersen’s national office whose job it was to coordinate the firm’s cross-selling efforts.⁴⁰ And, completing the snare into which the engagement auditor found herself, each auditor’s compensation was frequently linked directly to the overall revenues attributed to each audit client.⁴¹

38. See Ianthe Jeanne Dugan, *Depreciated: Did You Hear the One About the Accountant? Its Not Very Funny*, WALL ST. J., Mar. 14, 2002, at A1. See also Ken Brown & Ianthe Jeanne Dugan, *Sad Account: Andersen’s Fall From Grace Is a Tale of Greed and Miscues*, WALL ST. J., June 7, 2002, at A1 (reporting that Arthur Andersen adopted a program in 1998 that called upon engagement partners to double revenues from their clients by cross selling nonaudit services).

39. See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (prepared statement of Arthur R. Wyatt). Accordingly, technicians were eased out of management and became themselves consultants to the auditing staff who were increasingly being overseen not by the most talented auditors but those who could sell or possessed nonaudit technical skills. See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Lee Seidler, Deputy Chairman of the 1978 AICPA Commission on Auditor’s Responsibilities).

40. See Arthur Andersen LLP, *supra* note 37.

41. See, e.g., *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Lynn E. Turner, Chief Accountant, Securities and Exchange Commission 1998-2001) (magnitude of audit and consulting fees in combination measured the profitability of the audit client and services of the engagement partner); Janet Kidd Stewart, *Incentives Feed Audit Woes*, CHI. TRIB., Mar. 10, 2002, at C1 (end of the year evaluation of engagement partners focused on what “kind of business you brought in.”). There were even powerful incentives for engagement partners not to question former financial statements as the auditor’s pay would be reduced when such a restatement

Another more troubling explanation for the growth of nonaudit services was that management easily saw this as a way to keep the outside auditor on a short leash. Management, unhappy with the auditor's "second guessing" management's artful use of accounting principles, could, of course, threaten to terminate the relationship. Under the current regulatory regime, this threat can easily be stared down by the auditor; to replace the accountant requires a prompt public disclosure on SEC Form 8-K,⁴² raises eyebrows within the investment community, and likely invites inquiry from the SEC. On the other hand, reducing or eliminating the amount of nonaudit services provided by the auditor is not required to be disclosed on Form 8-K. Thus, the provision of significant levels of nonaudit services by the auditors provides management with greater leverage over the auditor in the event of disagreements between management and the auditors. Herein lies one of the major concerns underlying auditors providing nonaudit services to their audit clients. A further bond between the auditor and its client is that audit clients hire a significant number of their auditor's partners and staff to become members of their senior management.⁴³ Thus, the auditor frequently finds herself staring across the desk into the piercing eyes of a former colleague, or even boss.

There is no solid empirical support that nonaudit services in fact systematically compromise the quality of the outside accountant's audit.⁴⁴

occurred. *Id.*

42. See Item 4 of SEC Form 8-K of the Securities Exchange Act of 1934.

43. See generally Proposed Rule: Revision of the Commission's Auditor Independence Requirements, Securities Exchange Act Release No. 42,994, 72 SEC Docket 1901 (June 30, 2000) (detailing these practices). Note in this regard that Sarbanes-Oxley adds Section 10A(l), 15 U.S.C.A. § 78j-1(l) (West 2003), to the Exchange Act and bars auditors from certifying the financial statements of a reporting company if certain senior financial officers of the company have, within one year, carried out an audit of the reporting company for the auditing firm.

44. It remains a matter of speculation whether the accountant's oversight of its audit clients' financial statements was diminished by the Supreme Court's holding in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), that there was no aiding and abetting liability under the antifraud provision. Since accountants continue to be liable for misstatements and omissions in the financial statements they audit, see *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215 (10th Cir. 1996), *cf.* *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999), it is difficult to conclude that *Central Bank* provides any more than perhaps a false sense of security to the auditor. Arguably, the most significant weakening of the legal environment for auditing occurred earlier when the Supreme Court held that scienter was required for there to be a violation of the antifraud provision. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). By eliminating the possibility of negligence as a basis for liability, one might conclude that *Ernst & Ernst* induces less caution on the part of the auditors. There are at least two weaknesses to this argument. First, there is no reasonable basis to conclude that negligence was ever the standard or even an acceptable standard before *Ernst & Ernst*. See James D. Cox, *Ernst & Ernst v. Hochfelder: A Critique and Evaluation of Its Impact Upon the Scheme of the Federal Securities Laws*, 28 HASTINGS L.J. 569 (1977). Second, scienter was and continues to be an acceptable standard of fault under the antifraud provision. See, e.g., *Sanders v. John Nuveen & Co., Inc.*, 554 F.2d 790, 793 (7th Cir. 1977); *Keirnan v. Homeland*,

The one systematic effort toward examining this connection points in the other direction. The Panel on Audit Effectiveness studied 126 audit engagements and identified thirty-seven, or twenty-six percent, of companies studied in which nonaudit services were provided.⁴⁵ The Panel concluded that in none of these cases did the provision of nonaudit services compromise the quality of the audit; the Panel even opined that in one-fourth of the audits that were accompanied by nonaudit services, the consulting work had a positive impact on the quality of the audit.⁴⁶ The Panel report, however, did not probe the more subtle question of whether nonaudit fees or, even more generally, the total fees received from the client compromised the auditor's judgment; the Panel's focus was instead on whether the act of providing nonaudit services impeded the audit function.⁴⁷ Such a connection between the independence of judgment and rewards that are garnered by reaching client-friendly results has a good deal of intuitive support. Moreover, there are abundant anecdotal reports of professional judgments being so compromised.⁴⁸ This indeed is an area

Inc., 611 F.2d 785, 788 (9th Cir. 1980). Thus, the auditor who becomes aware of a possible misrepresentation committed by management, but turns a blind eye to further investigating would appear to have acted at least recklessly.

45. Public Oversight Board, *Panel on Audit Effectiveness Report and Recommendations* (Aug. 31, 2000), available at <http://www.pobauditpanel.org/>.

46. *Id.* at 113. See also K. Raghunandan et al., *Are Non-Audit Fees Associated with Restated Financial Statements? Initial Empirical Evidence* (unpublished working paper on file with the author) (Apr. 11, 2003) (finding no significant correlation between non-audit fees paid to auditors and likelihood of financial restatement); Rick Antel et al., *The Joint Determinants of Audit Fees, Non-Audit Fees, and Abnormal Accruals*, Yale ICF Working Paper No. 02-21 (June 14, 2002) (finding no higher frequency of abnormal accruals were correlated with higher audit or nonaudit fees, although other studies cited to in this paper have reached a contrary result); Richard M. Frankel, Marilyn F. Johnson & Karen K. Nelson, *The Relation Between Auditors' Fees for Non-Audit Services and Earnings Management*, MIT Sloan Working Paper No. 4330-02 (July 2002) (the greater the nonaudit services the more likely it is that analysts' forecasts will be met or exceeded and that there will be larger discretionary accruals).

47. See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Lee Seidler, Deputy Chairman of the 1978 AICPA Commission on Auditor's Responsibilities).

48. For example, in the Enron/Andersen case, an Andersen email reveals that members of the engagement team were concerned about Enron's financial statements, but that same email also cautioned that future work for Enron "could reach \$100 million per year." Jane Mayer, *The Accountants' War*, THE NEW YORKER, Apr. 22, 2002, at 64, 68. See also Flynn McRoberts & Delroy Alexander, *1-Stop Tactic Casts Cloud on Andersen*, CHI. TRIB., Mar. 4, 2002, at 1 (A former Andersen client is reported to have observed, "[T]he more consulting business we did with them, the more companies they would refer to me and the easier their audit partners would be in approving the deals."); John Cassidy, *The Greed Cycle*, THE NEW YORKER, Sept. 23, 2002, at 64 (reporting that Andersen's substantial consulting fees from Waste Management were reported by those involved as a reason why the auditor signed off on Waste Management's financials even after expressing doubt as to their accuracy); Jonathan Weil & Michael Schroeder, *Waste Management Suit By SEC Zings*

where it would not be foolish to trust one's intuition. Doing so, however, has significant implications for the choice between principles and rules:

[T]he loss of a client is a negative in one's career path. Since many decisions required of audit firm managers and partners are judgmental in nature, rather than clearly prescribed by extraneous forces, such judgments are, at the margin, sometimes influenced by perceptions of the attitudes of leaders of a given firm. If those perceptions by firm audit personnel are that the loss of a client is damaging to one's career path, the judgments made may be more in the direction of keeping the client than to achieving the fair presentation of financial statements.⁴⁹

The message may well be, therefore, that before adopting an approach that invites more discretion and judgment, as do generally-worded standards directed toward "fair presentations" of the firm's performance and financial position, there must be a healthy regard for the reward structure within which such decision-making occurs.

It is also possible to conclude that it is myopic to focus so intently on the revenues associated with nonaudit services. Audit failures predate the accounting industry's undertaking significant consulting activities.⁵⁰ Indeed, a good deal of the auditor's independence is compromised by the sheer magnitude of the audit fees associated with a client, especially if they view these fees as a perpetuity.⁵¹ With there being few instances of firms changing their auditors, the auditors can easily come to view the yearly audit revenues from a client as a perpetuity. So seen, the value of a client relationship can easily be determined by capitalizing the yearly audit fee at a low discount rate—low to reflect the small likelihood that the relationship will be terminated. This calculus yields a very high dollar value the engagement partner can place on preserving the relationship with

Andersen, WALL ST. J., Mar. 27, 2002, at C1 (SEC complaint alleges that soon after Andersen signed off on Waste Management's fraudulent 1993 financial statements, it was awarded a \$3.7 million consulting contract by Waste Management).

49. See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (prepared statement of Arthur R. Wyatt).

50. See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Harvey L. Pitt, Chairman, Securities and Exchange Commission).

51. See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Richard C. Breeden, Chairman, Securities and Exchange Commission 1989-93).

the audit client.⁵² It is that calculation that underlies the arguments advanced by those who favor the periodic rotation of auditors.

Just as the accounting firms transformed themselves during the 1990s to become lucrative consulting firms that also provided audit services, they also became, in that same period, a powerful lobbying force in Washington. Consider that the industry spent \$41 million on lobbying activities between 1997 and 2001,⁵³ and that each of the Big Five accounting firms were among the top 20 contributors to George W. Bush's 2000 presidential campaign.⁵⁴ Indeed, there may well be some irony in the statistic that of the 248 Senate and House members who sat on congressional committees involved in the numerous investigations prompted by the financial scandals of 2002, 212 of them had received contributions from one or more the Big Five accounting firms.⁵⁵ A significant issue for the accounting industry that drove it to become an important campaign contributor was the rising cost of litigation. An estimated twelve to fifteen percent of the accounting firms' audit revenues were consumed by their defense and settlements of securities fraud actions.⁵⁶ It comes as no surprise that the accounting industry's most visible lobbying success was the Private Securities Litigation Reform Act (PSLRA) of 1995,⁵⁷ which introduced a variety of defendant-friendly procedural and substantive requirements for the conduct of securities fraud suits.⁵⁸ Success with the PSLRA was followed by other successes on the part of a profession which appeared to have become ever the more

52. For example, the most recent audit fees Arthur Andersen received from Enron were \$25 million. If viewed as a perpetuity and capitalized at ten percent, the value of the Arthur Andersen-Enron relationship to Arthur Andersen was \$250 million.

53. See Center for Responsive Politics, at <http://www.opensecrets.org>. Their political donations increased yearly over the decade and were generally bipartisan, although a slight edge was enjoyed by the Republicans candidates in each year. *Id.*

54. See Stephen Labaton, *Now Who, Exactly, Got Us Into This?*, N.Y. TIMES, Feb. 3, 2002, § 3, at 1.

55. See Mark Fineman, *Donations Could Taint Probe on Capitol Hill*, L.A. TIMES, Jan. 18, 2002, at A1.

56. See Jim Kelly, *Accountancy: U.S. Cavalry May Come to the Aid of Big Six*, FIN. TIMES, July 13, 1995, at 10.

57. Pub. L. No. 104-67, 109 Stat. 737 (1995).

58. For a detailed account of the accounting industry's lobbying efforts, see John von Brachel, *CPAs on Capitol Hill: A Behind-the-Scenes Look at the Passage of Securities Litigation Reform*, J. OF ACCT., June 1996, at 15. See also John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996) (reviewing the legislative history leading up to the final enactment). An important supporting group in the lobbying efforts consisted of the high tech firms, but representatives of the large accounting firms were throughout a leading force. *Id.* (reporting that Silicon Valley proponents of reform were persuaded they would become the victims of a securities fraud class action if their stock declined substantially).

emboldened by its new friends on Capitol Hill. For example, the SEC's proposals to seriously restrict nonaudit work performed for the accountant's audit client were deflected by an intense lobbying effort.⁵⁹ And, former SEC Chairman Arthur Levitt observed it was the accounting industry's aggressive lobbying of the Financial Accounting Standards Board (FASB), when that body was considering the expensing of stock options, that caused him to conclude that the accounting profession was no longer aligned with investors.⁶⁰

So what has changed? Sarbanes-Oxley bars accountants from providing certain nonaudit services to their clients and mandates preapproval by the audit committee for those nonaudit services not barred that are to be performed for the client.⁶¹ At the time of this Article's publication, reports continue to confirm that auditors continue to earn from their audit clients significantly more from consulting than from the provision of audit services. For example, the *Wall Street Journal's* tally for the 30 companies that make up the Dow Jones Industrial Average shows that 62 percent of the revenues received by the auditors from their clients were for nonaudit services.⁶² The reported amount is down slightly from the figure the year

59. See Mike McNamee et al., *supra* note 3, at 157 (reporting that forty-six congressmen wrote to SEC Chairman Arthur Levitt within the four weeks of the proposal; of that number, forty-three had received political contributions from the accounting industry). The issue of accountant's independence was one of the factors that led to the demise of the Public Oversight Board. The SEC had directed the POB to conduct an independent investigation of independence standards followed by the Big Five accounting firms. This charge was met by funding being withheld from the POB by the SEC Practice Session, an arm of the American Institute of Certified Public Accountants that was created for the purpose of being the exclusive funding for the POB. After the POB agreed to undertake a more limited investigation, funding was restored, but its investigation was seriously hampered because the accounting firms did not cooperate fully. See PUBLIC OVERSIGHT BOARD, FINAL ANNUAL REPORT, 2001, at 3, 13, 36-7, 46 & 48, at <http://www.publicoversightboard.org/2001.pdf>.

60. See Arthur Levitt, *Take on the Street: What Wall Street and Corporate America Don't Want You to Know. What You Can Do to Fight Back*, reprinted in BUS. WK., Sept. 30, 2002, at 74. To be sure, the accountants were merely one among a larger chorus of voices raised against the expensing of stock options. See generally Greg Hitt & Jacob M. Schlesinger, *Perk Police: Stock Options Come Under Fire in Wake of Enron's Collapse*, WALL ST. J., Mar. 26, 2002, at A1 (reporting on mass rallies in Silicon Valley to oppose proposed action by the FASB); Julie Kosterlitz & Neil Munro, *Full Disclosure*, NAT'L J., Feb. 23, 2002, at 524 (recounting how both the Democratic and Republican leadership mobilized to capture support for their parties by creating organizations to attract support and funds around the issue).

61. See Section 201 of Sarbanes-Oxley amending Section 10A(g)(h) of the Securities Exchange Act, 15 U.S.C.A. § 78j-1(g)(h) (West 2003). There is a de minimus exemption in paragraph (h) for preapproval for nonaudit services that do not exceed five percent of the total fees paid to the auditor. Possible laxity in the pre-approval provision is suggested in the report accompanying this provision, which observes that the law "does not limit the number of non-audit services that the audit committee may pre-approve at one meeting or occasion." S. REP. NO. 107-205, at 20 (2002). Such an approach could lead to undesirable rubber stamping of extensive financial arrangements with the auditors over which management and not the audit committee would have influence over the auditors.

62. See Cassell Bryan-Low, *Accounting Firms Earn More From Consulting*, WALL ST. J., Apr.

before of seventy-five percent; however, the decline can be the result, in part, of the overall decline in consulting due to the stagnant economy. Investor concerns have caused some companies to terminate consulting projects with their auditors.⁶³ Moreover, there appears to be no mass movement toward the regular rotation of accounting firms. The relationship between auditor and client therefore continues to reflect a perpetuity. How members of the audit committee have changed their behavior in the post-Enron era, or in the shadow of the new requirements hastened in by Sarbanes-Oxley, remains to be seen. Each has at least supported a booming cottage industry for directors' colleges; so if the lesson has been learned one, therefore, has cause to expect that boards, at least in the near term, will be even more active in the review of their company's financial reports. We might take solace in the continuing increase in the number of earnings restatements. A leading forensic accounting firm found a record-setting number of restatements for 2002, with the number of restatements reaching 330, a twenty-two percent increase over those for the preceding year.⁶⁴ The restatements may well portend both a greater diligence on the part of the auditors as well as a stiffening of their resolve. Each, of course, would be hopeful signs of an improved financial reporting culture.

III. THE SUBSTANTIVE CLIMATE FOR THE PRINCIPLES VS. RULES DEBATE

The present principles-rules debate is taking place within an existing tapestry. There is good cause to doubt whether it is legally possible for rules to obscure a result that would be contrary to a core principle, such as the recognition of revenue. A coherent set of rules would always be anchored in their overarching policy. To be sure, those wishing to pervert the principle can also be expected to be as willing to pervert the rule that is to reflect the best thinking about what the principle is to mean in a particular case. But a perversion nevertheless it would be. Neither will

16, 2003, at C9. It should be noted that three of the Final Four accounting firms have split-off their consulting operations. Only Deloitte Touche Tohmatsu has not, recently canceling its efforts to do so because of the inability to finance the spin-off of its consulting operations. See Robert Frank & Deborah Solomon, *Deloitte Touche Cancels Plans To Split Off Its Consulting Arm*, WALL ST. J., Mar. 31, 2003, at C10. The spinning off of a firm's consultants does not mean that the auditing firm does no consulting. The spin-off involves a range of practice areas, but not all areas are spun off. The most obvious practice area that continues within the auditing firm is the provision of tax advice.

63. See, e.g., Cassell Bryan-Low, *GM Will End Consulting Projects With Deloitte Touche Tohmatsu*, WALL ST. J., Apr. 7, 2003, at C7.

64. See Huron Consulting Group Report, *supra* note 4. Surprisingly, the number of companies with over \$1 billion in revenues nearly doubled over the number in 2001. *Id.*

shield the parties from legal responsibility for their perversion.

The reason for this self-assured conclusion is the continuing vitality of *United States v. Simon*.⁶⁵ In *Simon*, two partners and a senior associate in a national accounting firm were convicted for knowingly certifying the financial statements of Continental Vending Machine Corporation because they knew, but did not disclose in the financial statements, that a reported receivable due from Valley (representing a loan to Valley by Continental) was not adequately collateralized, that Valley had lent the money to their mutual controlling stockholder, that there was great doubt it would be repaid, and that the loan amount had grown by more than ten percent in the period between the close of the fiscal year and the date the financial statements were certified.⁶⁶ Eight representatives from the accounting industry testified that neither generally accepted accounting principles nor generally accepted auditing standards compelled this information to be disclosed.⁶⁷ District Judge Mansfield refused to instruct the jury that the accountants could be guilty of fraud only if their conduct violated accepted accounting practices and the defendants had engaged in a willful departure from accepted accounting practices. Instead, he instructed the jury “that the critical test was whether the financial statements as a whole fairly presented the financial position of Continental.”⁶⁸ The Second Circuit upheld the instruction, emphasizing that the overall focus was, as occurred in the district court, on whether there was a “fair presentation.”⁶⁹ This holding is softened somewhat by Judge Friendly’s opinion acknowledging that the case was not one in which the accountant relied upon an articulated rule or prohibition for the accountant’s treatment of the receivable.⁷⁰ But, the point raised by Judge Friendly can be further qualified if the hypothesized rule were to reflect a broader principle, and the defendant’s aggressive use of the rule placed the principle on its head.

65. 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

66. *Id.* at 799-805.

67. *Id.* at 805.

68. *Id.* (internal quotation marks omitted). Accordingly, *Simon* can be seen as symmetrical with other conclusions reached under the securities laws. *Simon* holds that compliance with generally accepted accounting or auditing practices does not shield the accountant from responsibility if the accountant knows, or is reckless in not knowing, that consequently the financial statements misrepresent the company’s financial performance or position. On the other hand, failure to comply with GAAP alone does not offer a “strong inference” of fraud for purposes of pleading in securities litigation. *See, e.g., In re K-tel Int’l, Inc. Securities Litigation*, 300 F.3d 881 (8th Cir. 2002).

69. *Id.* at 909-10.

70. *Id.* at 806 (“We do not think the jury was . . . required to accept the accountants’ evaluation whether a given fact was material to overall fair presentation at least not when the accountants’ testimony was not based on specific rules or prohibitions to which they could point, but only on the need for the auditor to make an honest judgment . . .”).

Simon continues to be a beacon that guides disclosure toward a single objective: the fair presentation of the reporting firm's financial performance and position. That this objective trumps technical compliance with an applicable set of accounting metrics is underscored not only by the contemporary vitality of *Simon*,⁷¹ but also by initiatives first undertaken by the SEC and virtually duplicated in Sarbanes-Oxley that mandate executive officer certifications that must occur on a quarterly basis. The chief executive officer and the chief financial officer each quarter must certify that (1) the officer has reviewed the financial reports, (2) to the officer's knowledge the report "does not contain any untrue statement of material fact," and (3) to the officer's knowledge "the report fairly presents in all material respects the financial position and results of operations of the issuer."⁷² The effect of *Simon* and the executive certifications is to link all rules and their overarching principles into a requirement of fair presentation of the company's assets, liabilities, revenues, and expenses.

Moreover, the dialogue⁷³ now required between the auditor and the members of the audit committee reinforces this norm. As seen earlier, the auditor is to review with the audit committee the critical accounting estimates and choices that affect the reporting of the firm's financial performance and position. Not only are the CEO and CFO required to reflect on whether the financial reports fairly report the company's performance and position, but the audit committee similarly is to consider whether choices that were so made with respect to accounting estimates or principles prevented the required fair presentation. Obviously, the independence of the audit committee's assessment serves as a reminder to the certifying officers that their own assessment of these matters should be taken seriously. Any disagreement between the audit committee's own assessment and the bald certifications by the officers poses a conflict of

71. See, e.g., *Monroe v. Hughes*, 31 F.3d 772, 774 (9th Cir. 1994) (although dismissing a complaint against an auditor for its failure to disclose publicly its concerns regarding weaknesses in the firm's internal controls, the court recognized that fair presentation was not affected by non-disclosure, but would not permit a blind obeisance to GAAP or GAAS to preclude liability); *Seiffer v. Topsy's Int'l*, 487 F. Supp. 653 (D. Kan. 1980) (accountant who knows he is substantially assisting in fraud is liable even though in compliance with GAAP); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y.), *aff'd in part and rev'd in part*, 540 F.2d 27 (2d Cir. 1974) (accountants could not hide behind GAAP when they had serious doubts that a purchaser would be able to pay for an item purchased on credit); *Maduff Mortgage Corp. v. Deloitte Haskins & Sells*, 779 P.2d 1083 (Or. Ct. App. 1989) (rejecting instruction that accountant would be liable only if it failed to adhere to GAAP).

72. See Securities Exchange Act Rules 13a-14 & 15d-14, 17 C.F.R. §§ 240.13a-14 & 240.14d-14 (2002) (implementing Section 302 of Sarbanes-Oxley).

73. See discussion in text at note 23.

the type that likely will trigger the authority under Sarbanes-Oxley for the audit committee to retain its own independent advisors to review the matter. The possibility that the audit committee will resort to an independent evaluation of the fairness of the reporting presentation should cause executive officers to take their certifications seriously. This result is likely because officers should understand that conflicting views between the audit committee and the senior officers regarding “fair presentation” weaken the directors’ confidence in the executives and could, therefore, lead ultimately to a change in management. This dynamic also has implications for the audit committee members. Their own assessment is an important cog in the wheel that Congress and the SEC have established to assure accurate and fair financial reporting. To this end, not only is a dialogue mandated, but the auditor’s relationship, as seen earlier, is anchored in the audit committee, and the committee is rendered even more independent by its statutory authority to retain independent advisors in carrying out its mission. Overall, the strengthened requirements of the audit committee and the executive certifications interact to drive reporting toward principles, or at least a single principle, of fair presentation, and away from a more technical orientation toward rules.

IV. THE AUDIT COMMITTEE AND THE EFFECTIVE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Sarbanes-Oxley is historic not solely because of the volume of its amendments to the securities laws. The Act’s significance also arises because of the incursions it makes on matters that historically have been the exclusive province of the states—corporate governance. As seen above, the Act assigns specific tasks to the audit committee and confers broad rule-making authority on the SEC to amplify the committee’s charge. The resulting directives interact with the more generalized state law obligations of directors, at least until perhaps a second federal shoe drops, so that the audit committee’s discharge of its federal tasks will continue to be examined through the state law fiduciary duty lens.

Consistent with the monitoring role of outside directors, state law permits directors to rely upon the advice, reports, and opinions of their advisors. Their reliance is not permitted, however, when the directors have knowledge that makes their reliance unwarranted.⁷⁴ The widespread

74. See, e.g., MODEL BUSINESS CORPORATION ACT §§ 8.30(d), (e)(1), (e)(2) (2002). Section 8.30(d) reads in relevant part as follows: “In discharging board or committee duties a director, who does not have knowledge that makes reliance unwarranted, is entitled to rely on information, opinions,

concern that the independence of the auditors is compromised when the auditors provide extensive consulting services to their audit clients has yet to manifest itself in the case law. There is no direct precedent-rendering reliance upon an advisor unwarranted if the advisor enjoys an on-going consulting relationship with the company⁷⁵ or, more generally, if the advisor anticipates a past financially beneficial relationship to continue.⁷⁶ Indeed, by Sarbanes-Oxley and the proposed listing requirements of the NYSE and Nasdaq so clearly shifting the source of the auditor's relationship from management to the audit committee, the conclusion can well be that the newly invigorated audit committee provides even greater justification today than in the past for the directors to rely upon the reports made to it by the outside auditors. This link is further underscored by the requirements of Sarbanes-Oxley that not only bar a firm's auditor from providing several types of nonaudit services to its audit client, but also call for nonaudit services allowed under the Act to be pre-approved by the audit committee.⁷⁷ In this way, Sarbanes-Oxley directly confronts the problem described earlier, namely that auditing firms had evolved into multi-faceted practices where the revenues garnered in nonaudit areas posed a serious threat to the auditor's independence. Nevertheless, our disquiet should remain to the extent auditors provide nonaudit services to their audit clients, and it is management and not the audit committee that effectively controls that portion of the client-auditor relationship.

It should be observed, however, that Sarbanes-Oxley proscribes only the most serious types of nonaudit services, not *all* nonaudit consulting.

reports or statements, including financial statements and other financial data, prepared or presented by . . . one or more officers . . . [or] public accountants. . . ."

75. It would appear reasonable to conclude that directors could not rely on those portions of financial statements for which the auditor was certifying the accuracy of its own inputs into the financial reporting process. This could occur, for example, if the tax treatment was material to the presentation of an item and the auditor had been deeply involved in structuring the transaction so that its audit-consulting client could obtain the maximum benefits under the tax law with respect to a novel tax strategy.

76. The notable exception here involves special litigation committees. An important consideration in determining the independence of a committee charged with responsibility in assessing the corporate interest with respect to a derivative suit is whether the committee has retained counsel with no historical relationship with the company and, more to the point, the officers who are the focus of the derivative suit. *See, e.g., Einhorn v. Culea*, 612 N.W.2d 78 (Wis. 2000) (emphasizing committee's independence is linked to that of its counsel). On the linkage between the outside directors' review of conflict of interest transactions involving officers and securing truly outside counsel, see James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077 (2003).

77. *See* Securities Exchange Act Section 10A(g & h), 15 U.S.C.A. § 78j-1(g & h) (West 2003) (added by Section 202 of Sarbanes-Oxley). *See also* Rule 2-01(c)(4) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(4) (2003) (refines the list of prohibited services).

For example, the provision of tax advice continues to be a valuable part of the auditing firms' consulting practices to their clients.⁷⁸ Thus, the lure of nonaudit revenues still exists in important areas and can still pose, in certain instances, a serious threat to the independence of judgment by the auditor. Also, the Public Company Accounting Standards Board created by the Act has the power to constrict or qualify the eight types of nonaudit services that currently are proscribed by the Act⁷⁹ so that the prohibitions may not be nearly as sweeping in the future as they appear to be today. The audit committee must therefore always be attentive to the scale of the auditor's dependence on management judgments for continual consulting and other nonaudit revenues to assure that its reliance upon the auditors remains warranted.

This fear continues today, even after the enactment of Sarbanes-Oxley. The fount of the fear is not just that there continues to be a lot of nonaudit services that the auditors perform for their clients or that they correctly view their relationship to the firm as a perpetuity. The enactment of Sarbanes-Oxley, stepped up disclosure requirements by the SEC, and the enhanced listing requirements of the NYSE and Nasdaq have brought a seismic shift in the legal environment for financial reporting. Nevertheless, there is good cause for concern that the culture of accounting has not yet moved forward to reflect these changes. As seen earlier, auditors continue to have significant consulting relationships with their audit clients. Customs change slowly so that auditors and directors may too easily continue business as it was, without an ever-present awareness that management is no longer the auditor's employer. And, with respect to the nonaudit services the auditor performs, despite the preapproval requirement of Sarbanes-Oxley, realistically it is the management and not the audit committee that decides to award the consulting engagement to the auditors.

The degree of the audit committee's attentiveness to possible compromises in the auditor's judgment is unaffected by whether accounting metrics are principles-based or rules-based. Recall that *Simon* can be read somewhat narrowly because the reporting practice employed by the auditors there did not rest on a formal rule or exception to a principle. One of the forces that has driven accounting to become more

78. *Id.* See also Order Regarding Section 103(A)(3)(B) of the Sarbanes-Oxley Act, Securities Act Release No. 8222, 80 SEC Docket 142 (Apr. 25, 2003) (adopting on interim basis the status quo for auditor independence until further action by the PCAOB).

79. See Securities Exchange Act Section 10A(g)(9), 15 U.S.C.A. § 78j-1(g)(9) (West 2003) (added by Section 202 of Sarbanes-Oxley).

rules-based and less principles-based has been the desire by auditors to shield themselves from liability by being able to base their professional actions on precise rules.⁸⁰ In this way, *Simon's* qualifications may themselves contribute to the present rules-oriented approach of GAAP. Even though this may be so, it would be a fundamental subversion of *Simon* to permit a rule to cloud the vision of a principle. *Simon's* overall tenor is the need for information to be fairly presented, not merely in accordance with rules that operate independent of concerns about whether in combination they fairly present the firm's financial performance and position. Therefore, in a rules-based environment, the mandated audit committee dialogue must probe whether the auditors have found safe haven among the rules at the expense of an overall accurate report of the firm. On the other hand, a principles-based environment leaves a host of reporting issues to judgment that also pose the same threat of compromise if the auditors do not abide by their client being the audit committee and instead become captives of their own economic self-interest.⁸¹ Stated somewhat differently, the life of the audit committee and its overall effectiveness may well be no different in either a rules-based or principles-based reporting environment. In either case, the audit committee must be attentive to whether there is a fair presentation. For this reason, the SEC's recent study engaging the choice between rules and principles steers a course that lists toward principles by calling for "objectives-oriented" standard setting whereby accounting principles are adopted that contain a good deal of specificity in stating their objective.⁸² To be sure, audit committees, much like their auditors, may be more easily seduced by the sirens of rules than by principles because of the false comfort one finds in finite requirements. It is just much easier to engage a debate on more general principles than to bear the burden of establishing that a rule in a

80. See FASB Proposal, *supra* note 5.

81. See, e.g., Remarks of Robert Herz, Chair, FASB, May 16, 2002, reported in 34 Sec. Reg. & L. Rep. No. 20 at 813 (principles-based accounting "requires auditors to be true professionals and, as I say, stand tall"); FASB Proposal, *supra* note 5, at 5 ("The [FASB] Board emphasizes that, if adopted, a principles-based approach to standard setting would require changes in the processes and behaviors of all participants in the U.S. financial accounting and reporting process, not just the FASB and other standard-setting bodies."). Under a principles-based approach, "preparers and auditors would need to apply professional judgments in more circumstances, while the SEC, investors, creditors, and other users of financial information must accept the consequences of applying professional judgment, including some divergence in practice." *Id.* at 9. For a discussion of why it is that bias is more likely to be reflected under a principles-based than rules-based standards, see Max H. Bazerman, George Loewenstein & Dan A. Moore, *Why Good Accountants Do Bad Audits*, 80 HARV. BUS. REV. 97, 101 (2002) (citing research supporting conclusion that it requires very little ambiguity in a guiding standard to invite biased judgments).

82. See SEC Study of Principles-Based Accounting, *supra* note 5.

precise case perverts an underlying principle.

Against these considerations, the complete independence of the auditors is not only desirable, it is absolutely essential. It is difficult to believe that the audit committee, as it exists in the post Sarbanes-Oxley era, can assure a fair presentation in either a rules-based or principles-based environment if the auditor's agenda includes any dependence on the goodwill of management. To be sure, it remains too early to tell whether the accountants now view, as the law requires, their client to be the audit committee and not the senior management team. When there are demonstrative reports of multiple instances of an audit committee retaining a different accounting firm than the one that has historically served the company, there will then be a stronger basis than there exists today for concluding that the auditor's dependence on management has been severed. Similarly, there would be a greater basis to believe the system is working as planned if there were more evidence that audit committees provide the initiative for changing the financial reports from those proffered by management and concurred in by the auditors. Events such as these may well occur. But if the auditors are not as independent as embraced in the model of governance now embraced by Sarbanes-Oxley, the victims will include the members of the audit committee and the investors who rely upon their oversight of the financial reporting process.

Recall the dialogue that Sarbanes-Oxley requires between the auditor and the members of the audit committee. But more importantly, consider the vision of the audit committee members that underlies this dialogue. The safeguards introduced by Sarbanes-Oxley's treatment of the audit committee depend on the vitality of the interchange between the auditors and the committee members. This begins with the call for complete independence on the part of the committee members. The requirement of independence is to avoid scripted rituals between auditors and committees. That is, the call for a totally independent committee is a requirement that the committee reflect its independence not solely by evaluating the financial statements, but through a close analysis of the mandated dialogue that includes reviewing the written communications between the auditors and management on critical accounting matters as well as the critical accounting estimates and principles in preparing the financial statements. The financially literate requirements of the NYSE and Nasdaq recognize that the committee must be able to seek appropriate information from the auditors and to understand the auditor's reply. The committee is not to carry out the audit, but instead is to probe whether the numbers fairly present the position of the firm. The committee objectively is to satisfy itself that the financial reports are what they purport to be. To this end, the

committee is totally dependent upon the auditor's response to the committee's questions. The committee's financial literacy invites follow up questions and probing when the circumstances so warrant. It is at this juncture where the utopian view of the committee may not mesh well in practice. Committee members, for a host of reasons, may not be as diligent as they should, or they may overlook the nuance of the accountant's reply to a question. As a consequence, the questions that are contemplated by the mandated dialogue can serve no greater good than the answers they ultimately elicit. In the end, the audit committee is charged with a very substantial burden that requires its substantial reliance on the auditors. The question then becomes, how comfortable are we that the committee will get the right response or a response that is unvarnished from a management perspective.

Failure on the auditor's part to provide complete, accurate, and truthful responses to the committee's questions invites, in appropriate circumstances, doubts whether the committee's reliance was warranted. This failure will not likely be of a scale to expose the directors to liability under state law or federal law.⁸³ The personal liability of audit committee members is not the desired goal of Sarbanes-Oxley. The objective instead is improved financial reporting. As described above, the weakness within the mandated dialogue occurs not because the audit committee members will not ask the right questions, but because their advisor, the auditor, either provides incomplete or misleading answers or simply does carry out the type of review that will provide a trustworthy response. The audit committee's independence and the anchoring of the auditor's relationship in the committee are each mechanisms to assure greater independence on the part of the auditor. However, as seen above, the auditor's

83. The directors' conduct likely would be deemed not to be willful and, hence, protected from damages based on any state law claim by an existing immunity shield. See *Arnold v. Society Savings Bancorp, Inc.*, 678 A.2d 533, 540 (Del. 1996) (directors immune to suit for negligence in performing their disclosure obligations because of provision in company's charter). The directors' conduct also would likely be beyond the reach of the securities laws' antifraud provisions. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Doubts even exist with respect to whether this would rise to the level of recklessness so that liability could arise under the antifraud provisions of the securities laws where the necessity of pleading a strong inference on the part of the directors poses a significant hurdle in the path of those seeking to impose liability. Cf. *Rothman v. Gregor*, 220 F.3d 81 (2d Cir. 2000) (pleadings against accounting firm fell short of establishing strong inference of scienter); *Danis v. USN Communications, Inc.*, 121 F. Supp.2d 1183 (N.D. Ill. 2000) (mere negligent audit does not give rise to liability under Rule 10b-5); *Nappier v. Pricewaterhouse Coopers LLP*, 227 F. Supp.2d 263 (D.N.J. 2002) (though there was some indication of accounting irregularities the allegations fell short of creating a strong inference of scienter under Rule 10b-5); *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992) (recklessness "requires more than a misapplication of accounting principles.").

independence requires a complete severance from management; otherwise, the dialogue will not occur or will not have the fullness it would have had. It is at this juncture of the problem that the PCAOB can make a significant contribution to making audit committees effective guardians of stockholders' interests and also assure that principles can reign supreme over rules.

Sarbanes-Oxley created the PCAOB as an independent self-regulatory organization to, among its other powers, "establish or adopt, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports" for companies subject to the SEC reporting requirements.⁸⁴ The body of existing auditing standards and procedures is as vast as the lore that comprises GAAP. It is clearly a challenge for the new SRO to decide where to begin, what existing rules to adopt, and where to propose changes. It is the position of this Article that a core consideration throughout the PCAOB's actions should be fostering an environment for auditors to perform their vocation as professionals. If this occurs, then the dialogue now mandated for the audit committee will be a meaningful one: the principle of fair presentation of a firm's financial performance and position will prevail regardless of any countervailing rules that may project a more favorable report of management's stewardship.

84. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, Section 101(c)(2) (2002); 15 U.S.C.A. § 7211 (West 2003).

